ASIC

Australian Securities & Investments Commission

Regulators at the forefront of change

A presentation by ASIC Commissioner Belinda Gibson to the Company Directors Conference 2009*

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*Note: this paper was presented in an abridged form at the Conference.

Outline

I think today's session can be paraphrased as "Where are the Regulators going to take us now in response to the Global Financial Crisis?", or perhaps – "Where are the Regulators going to make us go?".

I propose to outline ASIC's major post GFC regulatory responses that are most relevant to you as company directors. I will start with a necessarily (and assuredly) brief review of our economic position, relative to the other major economies. That's a pretty good story. That will lead to a discussion of the fundamental regulatory structure questions that are being faced overseas. Then I will pick up the specific initiatives we are working on, first with the overseas regulators and then specifically in our own markets. The objective of all ASIC's work is to restore confidence in the markets, so investment and lending can resume.

Where do we stand?

Australia's economy and its key financial institutions are relatively strong compared to the other leading markets of the US, UK and Europe. Aside from the fact we have (thus far) seemed to escape technical recession, here are some positive statistics.

- Australian banks have not received or required nearly the level of financial support from government that the US and European banks have.
- Credit growth slowed to 4.9% to March 2009, but that is more buoyant than overseas.
- Australian corporations have raised significant debt funding offshore – some $85b of long term debt since November 2008.
- Australian corporations have raised about $53b of capital on the ASX since November 2008, 5.5% of market capitalisation. The figure is 1% for the New York Stock Exchange and 2.5% on the London Stock Exchange.

But:

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- The S&P/ASX 200 Index lost 54% from November 2007 to March 2009, though it has recovered to just 25.1% to 5 June 2009. This lines up with overseas markets. It is 52.2% of 2008 GDP.
- Major corporate insolvencies and market failures account for some $73b of lost value or 6.2% of 2008's GDP. That's more than the 1988 market crash.
- Insolvency statistics have reached an all time high and the economic downturn is clearly affecting the real economy and real people.

In summary, the economy is suffering and all forecasts show it will continue to do so for a while. However, Australia has not suffered the massive assault on its leading financial institutions that has occurred in the US and Europe.

Regulatory Reshaping

As a consequence we in Australia have not had to undertake the fundamental review of regulatory structure that is going on overseas. We can focus on an orderly unwind and lay the foundation for the recovery that we are seeing emerge.

The US is not in such a fortunate position. The House Committee on Financial Services Chairman, Barney Frank, has spoken of entering the third era of economic history. He notes a pattern of private sector innovation beyond the regulatory reach. At some point there are negative consequences that require significant public sector intervention. In the early 20th century it was trust busting. In the 1930s the SEC was established to regulate the stock markets. The new round of innovation that must be dealt with now is securitisation.

The US is debating a twin peaks model, one arm of which coordinates prudential oversight of all banks, and the other has responsibility for market conduct. Should the SEC, which is confined to stock market regulation, merge with the CFTC, which regulates the traded derivatives markets? What about the largely unsupervised OTC markets, or the wholly unregulated insurance groups and hedge funds?

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In the UK the Chairman of the Financial Services Authority, Lord Turner, has released a lengthy paper on the requirements for regulatory reform to respond to the root causes of the GFC. He speaks of international boom and bust cycles and the need for a new model for delivering credit intermediation. The banking institutions must be protected from irrational trading. Capital adequacy and liquidity requirements must be revisited.

A constant theme of regulators is that future financial activities are to be regulated by economic substance and not form. It would seem the opportunities for regulatory arbitrage are reducing, at least for the systemically significant institutions.

Of course Australia is not ignoring these developments. Together with Treasury, APRA and the Reserve Bank, we at ASIC are participating in many of the global reviews of the events that have occurred and the regulatory changes that are needed. The global economy is highly integrated. It is not realistic to think we can be isolated and immune from the contagion in global markets, like some sort of swine flu. We need to ensure our regulatory system adapts with those of other countries. There is no need for major institutional change, but there is need for attention to practices that have proven problematical.

Global financial turmoil – some causes:

There are countless studies now emerging about the causes of the global financial crisis. Hyman Minsky's studies of 1966 seem to have found some favour – all culminate in irrational lending where repayment is dependent on ever upward revaluations of the underlying assets.

Let me proffer a short list of some market features that seem to have contributed to the GFC, and are being addressed in the various global fora:

- Sub-prime mortgages in the US sold to investors globally.
- Over leverage in major trading houses.
- Complex financial instruments dealt off market, leading to extreme and unassessable counterparty risks.

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- Risk mismanaged – mispriced, separated from underlying assets, and separated from reward structures.

What is the focus of global financial regulators?

First and foremost, we are concerned with rebuilding confidence in the financial system. We must reopen the markets for capital raising and for lending. I will return to this theme later, under the topics of market turmoil and market integrity.

A lot of work is being undertaken to analyse the regulation of over-the-counter markets. The major uncertainty at the collapse of Lehman Brothers was its derivative counterparty exposure. There was no means of ascertaining the extent of its liabilities and what damage its collapse could inflict on other entities. In the US there are calls for more OTC product standardisation, transparency and introduction of regulated markets with a central counterparty. We have started a review of the OTC derivative markets here. A combined ASIC, RBA and APRA survey was released on 22 May 2009. It is the start of a dialogue with industry in coming weeks, with a view to enhancing transparency, collateralisation and infrastructure development.

A common phrase (amongst us regulators anyway) is "systemically significant entities" - the entities that more colloquially are "too big to fail", because of the knock-on consequences. These include the major hedge funds and private equity houses. In the US it includes insurance groups like AIG. As I mentioned earlier, these have escaped substantive regulation. By regulation I mean prudential supervision – which APRA was established to do and has done so effectively through this crisis.

We at ASIC provide AFSLs to some hedge funds and some private equity houses. Whether closer supervision is required is for discussion in the future – though these houses have not achieved the giddy heights of systemic significance in our market at this point.

Three other common topics for discussion at global regulators meetings are:

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- The role of fair value accounting – has mark to market accounting exacerbated the boom/bust features of the cycle? There has been some tweaking of the measures but the system stands.
- The role of credit rating agencies – the CRAs are classic gatekeepers; apparently independent professional organisations that we rely on to discern (and tell us) the full picture. We have not seen significant wholesale ratings failures here in Australia, but the industry is a global one and there have certainly been failings overseas that have promoted a revised regulatory stance. We are moving to a globally consistent model here.
- Executive remuneration – the pay models of the major investment houses are said to be flawed. There is inadequate consideration given to risk in determining rewards. The shareholders unfairly share risk but not reward. As you are all aware, both APRA and the Productivity Commission are examining these issues here.

Market Turmoil - ASIC's focus

I want to turn now to responding to the stock market turmoil, just a subset of the global financial turmoil. As I have said, the big focus here is restoring confidence in the capital markets. This means that we must promote market integrity – the attributes of transparency and fairness that set our market above many.

Why does integrity matter? There are many academic studies that show that a market with strong indicators of transparency and fairness and a strong reputation for enforcement of the rules has a lower cost of capital. Bid/ask spreads are lower. There is also the more psychological issue of fairness. People are more inclined to trade in the market if there is no perception that insiders or strong entities can profit ahead of others.

What are the major projects that we at ASIC have undertaken in the last 12 months that directly impact you as company directors?

- <u>Short selling</u> – in September last year we introduced a ban on all short selling in our market. We finally

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lifted the ban on financial stocks last month, pleasingly without significant market disruption. The next issue will be the final disclosure regime and Treasury's regulations are due shortly.

- Insider trading – in 2008 we commenced a very focussed enforcement program, targeting prosecution of the insider trading and market manipulation offences. We have worked closely with ASX in detection and with the CDPP in prosecution. We have finessed our own processes. At present we have formal investigations into some 32 possible insider trading breaches. Thirteen of these involve company directors. Recently the Queensland Supreme Court handed a hefty two year sentence with a minimum 14 months to serve to a company officer who traded illegally. Be in no doubt – ASIC will not hesitate to prosecute company directors who steal company information and use it to profit on the stock market. We will seek jail terms. It is very risky behaviour.

- Rumourtrage – since March 2008 there has been a lot of talk about the prevalence of damaging rumours in the market, spread by predatory short sellers looking to profit when the price hits a low trigger point. This has been a global phenomenon. We set up Project Mint to look for illegal conduct around false stories in the market. We have made numerous enquiries and continue some formal investigations. The next stage of the project will be to issue a consultation paper to the market about the best practices that stock market participants and investment houses should adopt when dealing with rumours. It can be difficult sometimes to distinguish spreading a false story with manipulative intent and the expression of a bona fide rational opinion that is perhaps contrarian. These principles will need to work in bull markets as well as bear markets.

  I encourage you, as directors, to participate in the discussion. You are the people who must respond to rumours in the market. You perhaps have an interest in shutting down all discussion – but is that a good outcome for price discovery in the market?

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I also encourage you to report to us false rumours that you find price manipulative, so we can make our inquiries. We set up a hotline earlier this year but there is a marked reluctance to use it. We cannot assist you without that information.

- Preventing information leakage – the key to an illegal rumour is that it is false. Many of the rumours I see in the market are not false – they have at least an element of truth that has somehow leaked, sometimes deliberately through "soundings". You as directors must do more to prevent leaks from your companies and your advisers. We have started a project that looks at confidentiality procedures before major transactions. I expect some best practice guidance in the next six months on this topic.
- Facilitating capital raising – since January this year the major corporates have raised significant amounts of capital on the ASX. I expect many more companies will seek to do so as debt funding becomes tighter and as the economic conditions improve and growth is a realistic prospect. We will shortly issue two regulatory guides that are designed to facilitate equity capital raisings by rights issues and share purchase plans. We are keen to ensure all shareholders can participate fairly in these raisings.

Disclosure focus

The Wallis Committee in 1997 reviewed our financial system and its conclusion was that the capital markets of Australia are best advanced by a light touch regime. The key is good disclosure and transparency of the markets. Prudential standards are not necessary except for the systemically significant ADIs and insurance companies.

The global financial crisis has exposed some areas for further work. One is financial literacy. Good disclosure assumes a knowledgeable reader. The past ten years has seen the rise of complex financial instruments in our market and they are commonly offered at the retail level. These types of products simply would not be offered to the retail markets in the US or UK.

ASIC has embarked on a financial literacy program but some of these products are too complex for the most

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sophisticated bankers, as evidenced by the GFC. We are rolling out a "invest between the flags" campaign – only invest where you know where it is safe and you understand where the markets' shoals lie.

We must also look more closely at disclosure practices in the market. There are some 20 projects in ASIC at the moment that are considering better disclosure.

A number directed to the capital markets will be rolled out in the next month, starting with guidance on continuous disclosure by unlisted disclosing entities. Others will follow in the next 12 months.

Let me briefly recap the four elements of our disclosure regime:

- IPO prospectus or PDS – must be clear, concise and effective
- Annual reporting
- Continuous disclosure – it must be timely, clear, complete and accurate.
- Transaction approval resolutions.

In short and in conclusion - better disclosure will need to do some heavy lifting as we direct our focus to the economic recovery phase. Our intention is not to make disclosure longer or harder for you – but focus attention on clearer, shorter documents that make the real risks abundantly clear to the average reader. We believe this will build the confidence of investors to re-enter the market.

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